A 7000-1

May 1986

Outlook for the Economy and Real Estate

REALTOR®

Forecasting & Policy
Analysis Division
NATIONAL ASSOCIATION OF REALTORS®
777 14th Street, N.W.
Washington, D.C. 20005

Outlook for the Economy and Real Estate

First Quarter Growth Rate Up Sharply

The Commerce Department's preliminary estimate of the growth of real or inflation-adjusted Gross National Product (GNP) for the first quarter is 3.2 percent, up sharply from the 0.7 percent growth rate of the final quarter of 1985 and significantly higher than our April forecast of 2.5 percent. The higher than anticipated growth rate was due primarily to stronger consumer spending and inventory building combined with a decline in the merchandise trade balance. Despite this resurgence in the overall growth rate, the underlying data suggests that the economy remains sluggish and that overall growth should weaken during this second quarter. Here are the first quarter highlights:

	Contribution to First Quarter Growth Rate (Percentage Points)
1) Consumption expenditures were up 4.3 percent in real terms compared to an increase of just 0.1 percent during the previous quarter. At the same time the personal saving rate increased to 4.3 percent from 4.0 percent. However, the increases in consumer spending were for nondurable goods and services. Purchases of big ticket durable goods such as automobiles, furniture, and appliances declined.	2.7
2) As lower mortgage interest rates have stimulated housing construction, residential fixed investment increased 9.7 percent in real terms compared to a 5.7 percent increase during the previous quarter.	0.5
3) In response to the decline in the value of the dollar and falling oil prices, exports rose a strong 11.9 percent while imports actually declined. Thus, the merchandise trade balance declined, boosting domestic economic growth.	1.7
4) Despite sharp declines in interest rates, business investment in new plant and equipment declined 13.6 percent in real terms during the first quarter. While the sharp cutbacks in capital spending in the oil industry have exacerbated this problem, business capital spending in general is expected to be weak this year due to declining capacity utilization, particularly in durable goods manufacturing industries.	-1.9
5) Spending restraint by the federal government has offset modest increases by state and local governments to result in a 15 percent decline in public sector purchases of goods and services.	-3.3
6) Inventory investment increased by $32 billion following a decrease of $4.5 billion during the fourth quarter of 1985. Farm inventories increased by $24 billion due to declines in purchases by the Commodity Credit Corporation. Nonfarm inventories increased by about $8 billion. The nonfarm inventory build-up was concentrated in the automobile industry where inventories have risen from 2.3 months supply in January to 3.1 months supply in March.	3.5
TOTAL	3.2

Due to lower food and energy prices, inflation, as measured by the GNP fixed-weight price index, slowed to an annual rate of 2.2 percent during the first quarter, down sharply from the 3.9 percent annual rate of price increase of the final quarter of 1985. Payroll employment growth increased by about 100,000 fewer jobs than during the previous quarter as industrial production declined in response to rising inventories. Declining production levels were very evident in the domestic automobile industry where production declined from a 9.7 million unit annual rate in January to a 7.5 million annual rate in March. Consequently, the unemployment rate rose slightly over the quarter to 7.1 percent from 7.0 percent during the previous quarter.

Weak Second Quarter Expected, Followed by Modest Rebound

At this point it looks as though the economy will weaken during this second quarter, with growth of real GNP falling to about 2 percent. Industrial production, particularly for consumer durables, is likely to decline over the quarter as businesses deplete the unwanted inventory buildup of the past six months. Thus, while consumer spending, residential investment, and net exports should register healthy increases, inventory investment should be negative over the quarter and drag down the overall growth rate.

Once this inventory correction is completed, the positive influences of lower oil prices, lower interest rates, and the reduced value of the dollar should combine to produce a modest rebound of the economy. Real growth rates should return to the 3 to 3-1/2 percent range during the second half of this year and the first quarter of 1987. Overall growth of real GNP for 1986 should be about 2.4 percent compared to 2.2 percent in 1985, increasing to about 2.8 percent in 1987. The underlying trends producing this type of growth path are as follows:

1) As economic expansions mature the overall growth rate subsides, leading to slower growth of household income. This, combined with increasing household debt burdens and declining personal savings rates, leads to slower rates of increase of consumer spending which represents about 65 percent of GNP. This typical trend is evident in the current expansion, which is now in its fourth year, although it is being interrupted by the decline in oil prices which directly increases consumers' purchasing power through lower prices for gasoline and other oil-based products and by the increases in household net worth resulting from strong stock and bond rallies. Another factor contributing to a resurgence of consumer spending is an awareness that the decline in the dollar is likely to increase the prices of many popular products in the near future. However, by the second quarter of 1987 the underlying trend of a mature expansion should reassert itself.

2) While housing starts are likely to remain in the 1.9 to 2.0 million range for the remainder of the year, the fact that starts will be stable rather than increasing means that the contribution of residential investment to economic growth will likely decline over the remainder of this year. In 1987, as starts taper off, the contribution of residential investment should become negative.

3) Business investment in new plant and equipment is likely to remain weak over the course of 1986, particularly for structures, due to low capacity utilization rates and high office vacancy rates. A recent survey by the Department of Commerce revealed that businesses plan to increase investment spending this year just 1 percent compared to actual increases of 7.5 percent in 1985 and 15 percent in 1986. In 1987 it should start to pick up as the decline in the dollar provides needed stimulus to the domestic manufacturing sector.

4) The fall of the dollar relative to the currencies of Japan and Western Europe should provide a gradually improving trade balance over the entire forecast horizon, boosting economic growth. However, given the fact that foreign trade is a relatively small component of GNP this stimulus to growth will only partially offset weakness in other sectors.

5) Given the spending restraint imposed by the need for deficit reduction, government spending for goods and services is likely to decline, actually retarding overall economic growth. This forecast assumes that the second round (FY 1987) of Gramm-Rudman-Hollings spending cuts are made, reducing the federal deficit to about $155 billion in 1987.

6) With relatively modest economic growth employment growth should just keep pace with growth of the labor force, causing the unemployment rate to remain fairly constant around 7 percent.

7) The beneficial impact of lower oil prices on inflation will subside, resulting in some acceleration of inflation as the decline of the dollar boosts import prices and the more rapid rate of price increase in the service sector reasserts itself. The overall increase of the Consumer Price Index should decline to about 2.5 percent in 1986 and then return to 3 percent or higher in 1987.

Monetary Policy and Interest Rates

Interest rates continued to decline during the first two-thirds of the month of April culminating in another cut in the FED's discount rate from 7 percent to 6-1/2 percent on April 18. The yield on 30-year Treasury bonds declined from about 7.7 percent to about 7.2 percent over this three week period as the bond rally was fueled by declining oil prices, evidence of a sluggish economy, and widespread anticipation of additional easing of monetary policy by the FED. The yield on 3-month Treasury bills also declined sharply, from about 6.3 percent to 5.8 percent, while most major banks reduced their prime rate from 9 percent to 8-1/2 percent.

However, over the three days of April 22, 23, and 24, bond prices tumbled and yields on 30-year Treasury bonds rose about one-half percentage point in response to a sharp decline in the value of the dollar relative to the Japanese yen. Bond market participants feared that with the decline of the dollar, Japanese investors would reduce their purchases of U.S. government debt at upcoming auctions, contributing to a general increase in interest rates. During the last week of April these fears subsided as the dollar stabilized, leading to some modest declines in interest rates. However, over the course of the month both long-term and short-term rates were down only about one-quarter of a percentage point.

While the declines are likely to be much more gradual, we continue to expect further reductions in interest rates over the remainder of this year and into 1987. The forces propelling this decline are the expectations of low inflation, relatively modest economic growth, the decline in the deficit due to Gramm-Rudman-Hollings, and the commitment of both the Treasury and the FED to reduce interest rates worldwide through coordinated policy actions with the governments of Western Europe and Japan. Over the remainder of this year the 30-year Treasury bond yield should decline from the current level of about 7-1/2 percent to 7 percent while the yield on 3-month Treasury bills should decline from the current 6.1 percent to about 5-1/2 percent. Rates on 30-year fixed rate mortgages, currently in the 9-1/2 to 10 percent range should decline to about 9 percent.

Housing Markets

Housing markets continue to respond favorably to the lowest mortgage interest rates since 1978. In March existing single-family homes were sold at a seasonally adjusted annual rate of 3.23 million units, down a slight 1.2 percent from the February pace but up 7.7 percent over a year ago. Total private housing starts were at a 1.95 million unit pace in March, also down slightly from the February pace but up over 5 percent over March of 1986. Single-family starts were actually up slightly while multifamily starts were down 7 percent, continuing their erratic path of the past year. Sales of new single-family homes (those purchased after construction has started) rose 27 percent in March to a seasonally adjusted annual rate of 903,000. Inventories of unsold new homes dropped sharply to just 4.6 months supply, supporting the view that starts should remain strong for at least the remainder of this year. For all of 1986 we anticipate about 3.4 to 3.5 million existing home sales and about 1.95 million housing starts. Affordability conditions should remain favorable in 1987, keeping resales at the 3.5 million unit level. However, housing starts should taper off to about 1.9 million units, with most of the falloff occurring in the multifamily category where rental vacancy rates are relatively high.

The increase in housing sales has brought with it faster rates of home price appreciation. Over the past few years home prices have been rising at roughly the overall rate of inflation. Currently, however, while overall inflation is declining, home price appreciation is picking up. In March the median price of existing homes sold was $80,000, up 7.2 percent over a year ago. The average price of new homes sold in March was up 9.4 percent over a year ago. In fact, the NAR Affordability Index dropped slightly in March as the increase in the median home price more than offset the increase in family income and the decline in mortgage interest rates. For all of 1986 prices of existing single-family homes should rise about 6 percent compared to 4 percent in 1985.

Commercial and Industrial Construction

Despite the fact that mortgage interest rates have declined to their lowest levels since 1978, the outlook for construction of new commercial and industrial structures during 1986 is for generally lower levels of activity, particularly for office buildings. The unprecedented office building boom of the last several years appears to have peaked in mid-1985. With the nationwide average office vacancy rate at about 17 percent, a major market correction is in process. Contracts for new office structures, which reached 330 million square feet in 1985, should decline about 30 percent in 1986 to about 230 million square feet. Construction should further decline in 1987 with little or no improvement until the end of this decade by which time growth of white-collar employment should have absorbed the current oversupply.

In response to strong residential building in both 1985 and 1986, demand for retail structures such as stores and warehouses should remain strong. For all of 1986 construction of about 575 million square feet of such structures should be started, down a modest 2 percent from the 1985 level.

Construction of new industrial buildings should also decline modestly this year to about 140 million square feet, down about 6 percent from the 1985 level. This level of new construction is sluggish due to an overall industrial capacity utilization rate that has hovered at 80 percent for the past few years. However, this market should improve over the remainder of the decade as the manufacturing sector of our economy is likely to be a major beneficiary of the reduced value of the dollar.

Table 1

Commercial and Industrial Building Contracts

Year	Stores and Other Commercial		Office Buildings		Industrial Buildings	
	millions of sq ft	percent change	millions of sq ft	percent change	millions of sq ft	percent change
1981	337	-11%	325	+15%	187	-13%
1982	245	-27%	261	-20%	118	-37%
1983	362	+48%	281	+ 8%	107	-37%
1984	478	+32%	318	+13%	144	+33%
1985	585	+22%	330	+ 4%	149	+ 3%
1986[f]	575	- 2%	230	-30%	140	- 6%

f: forecast

Source: Historical Data: DRI, Review of the U.S. Economy, April 1986.
Forecasts: NATIONAL ASSOCIATION OF REALTORS®

TABLE 2

U.S. ECONOMIC OUTLOOK

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1984	1985	1986	1987	1988
AGGREGATE ECONOMY													
Gross National Product													
(billions of dollars)	4,059	4,117	4,163	4,220	4,280	4,345	4,402	4,464	3,775	3,989	4,195	4,434	4,710
% Change	4.3	5.8	4.5	5.6	5.9	6.2	5.3	5.7	11.0	5.7	5.2	5.7	6.2
% Change (w/out inflation)	0.7	3.2	2.0	2.9	3.5	3.2	2.1	2.5	6.6	2.2	2.4	2.8	2.8
Consumption	0.1	4.3	2.4	3.2	3.1	2.4	0.5	0.7	4.4	3.3	2.9	1.9	1.7
Durables	-13.3	-1.5	1.6	4.8	4.9	2.8	-3.4	-0.2	12.4	8.4	1.2	1.5	2.5
Nondurables	0.6	7.7	2.5	2.9	2.8	2.3	1.2	0.9	3.4	2.3	3.4	2.0	1.6
Services	4.4	3.4	2.6	2.9	2.8	2.3	1.2	0.9	3.0	2.5	2.9	2.0	1.8
Residential Investment	5.7	9.7	13.6	1.0	0.7	-0.3	-1.3	-1.7	13.2	1.7	7.6	0.4	-0.6
Nonresidential Investment	11.3	-13.6	8.3	4.3	6.8	4.7	2.4	4.0	19.5	9.7	1.8	4.6	4.0
Structures	7.2	-5.1	0.4	1.3	4.1	4.7	3.3	4.2	14.7	11.4	1.0	3.5	3.9
Equipment	13.5	-17.8	12.9	5.9	8.2	4.8	1.9	3.9	22.2	8.8	2.3	5.2	4.0
Exports	6.6	11.9	5.9	6.5	6.9	7.4	7.6	7.9	6.2	-3.0	5.0	7.3	8.1
Imports	24.5	-3.6	2.1	1.9	2.2	1.2	-0.2	-1.4	22.8	2.7	6.6	0.7	-0.2
Government Purchases	9.2	-15.1	-3.0	-1.4	0.6	0.7	0.4	0.4	4.3	6.0	-0.8	0.1	0.3
Contribution to GNP Growth													
Consumption	0.1	2.7	1.6	2.1	2.0	1.5	0.3	0.5	2.2	1.9	2.1	0.8	1.6
Residential Investment	0.3	0.5	0.6	0.1	0.0	0.0	-0.1	-0.1	0.2	0.3	0.3	-0.1	0.0
Nonresidential Investment	1.4	-1.9	1.1	0.6	0.9	0.6	0.3	0.5	1.9	0.8	0.1	0.4	0.6
Structures	0.3	-0.2	0.0	0.1	0.2	0.2	0.2	0.2	0.6	0.4	0.0	0.2	0.2
Equipment	1.1	-1.7	1.0	0.5	0.7	0.4	0.2	0.3	1.3	0.5	0.1	0.3	0.4
Inventory Change ($ billions)	-0.5	3.6	-0.9	0.1	0.1	0.3	0.6	0.5	0.4	-1.2	0.7	0.5	0.1
Net Exports	-2.3	1.7	0.3	0.4	0.4	0.6	0.8	1.0	-1.5	-1.2	0.7	0.9	0.8
Government Purchases	1.8	-3.3	-0.6	-0.3	-0.1	0.1	0.1	0.1	1.5	1.5	-1.0	0.1	0.0
Mfg. Capacity Utilization Rate	80.1	80.0	79.3	79.5	79.9	80.2	80.1	80.3	80.8	80.3	79.6	80.2	81.4
Domestic Auto Sales (millions)	7.0	7.9	7.6	7.6	7.6	7.7	7.2	6.8	8.0	8.3	7.7	7.1	6.7
Personal Income Per Household	40,616	41,058	41,357	41,661	41,983	42,369	42,714	43,082	38,175	40,029	41,508	42,914	44,712
Percent Change	4.5	3.9	3.4	3.5	3.4	3.2	3.3	3.4	10.4	4.9	3.7	3.4	4.2
Personal Taxes Per Household	6,156	6,088	6,158	6,229	6,303	6,279	6,340	6,405	5,420	5,987	6,194	6,392	6,664
Percent Change	1.3	-1.1	1.2	1.2	2.4	3.1	3.0	2.8	12.2	10.5	3.4	3.2	4.3
Percent of Personal Income	15.2	14.8	14.9	15.0	15.0	14.8	14.8	14.9	14.2	15.0	14.9	14.9	14.9
Disposable Personal Income Per Household	34,460	34,970	35,199	35,431	35,681	36,090	36,374	36,677	32,755	34,042	35,314	36,523	38,048
Percent Change	3.7	4.7	2.4	3.7	3.5	3.2	3.3	3.5	10.7	3.9	3.7	3.4	4.2
Employment (millions)	116.2	117.0	117.4	117.8	118.1	118.5	118.9	119.2	113.5	115.5	117.6	119.0	120.3
(civilian:household basis)													
% Change	2.4	3.0	1.2	1.3	1.2	1.3	1.3	1.2	1.8	1.7	1.8	1.2	1.1
Unemployment Rate (%) (civilian)	7.0	7.1	7.1	7.1	7.0	7.0	7.0	7.0	7.5	7.2	7.1	7.0	6.7
Consumer Prices (CPI)	4.4	2.0	1.7	1.8	1.7	4.0	4.1	4.1	4.3	3.5	2.5	3.2	3.7
GNP Deflator	3.3	2.5	2.6	2.6	2.2	2.9	3.1	3.1	4.1	3.3	2.8	2.8	3.3
Personal Cons. Inflation	4.4	1.1	2.0	1.9	1.6	3.8	3.9	3.9	4.1	3.2	2.3	3.1	3.5
Residential Construction	5.7	3.3	3.2	3.9	3.2	3.0	3.3	3.6	4.2	1.9	3.4	3.4	4.2
Nonresidential Const. Inflation	0.8	4.0	3.4	3.9	3.9	3.2	3.6	3.8	0.5	1.4	2.7	3.6	4.3
Producer Price Inflation	4.7	-5.7	-0.5	0.8	1.4	3.8	3.9	4.2	2.1	0.9	-0.5	2.8	4.5
Before-Tax Corporate Profits	239.8	216.5	223.9	238.0	247.1	263.0	268.2	277.5	237.6	226.8	231.3	273.5	312.9
Corporate Tax Liability	90.3	81.5	84.3	90.3	94.0	101.3	103.6	107.8	93.6	85.9	87.5	106.0	123.1
After-Tax Profits	149.5	135.0	139.6	147.7	153.1	161.7	164.6	169.7	144.0	140.9	143.8	167.5	189.8
Inventory Valuation Adjustment	-10.1	14.2	1.9	-4.0	-5.0	-15.0	-15.7	-18.2	-5.4	-0.6	1.8	-17.3	-21.7
Capital Consumption Allowance	79.4	81.7	84.3	88.4	92.7	97.5	102.1	106.5	41.0	70.9	86.8	104.2	105.8
Federal Tax Receipts (NIPA)	806.2	805.3	814.9	827.5	838.7	851.4	860.7	872.1	725.1	785.4	821.8	868.3	922.4
% of GNP	19.9	19.6	19.6	19.6	19.6	19.6	19.6	19.5	19.2	19.7	19.6	19.6	19.6
Federal Expenditures (NIPA)	1030.4	1008.6	998.0	998.8	1003.8	1010.4	1017.5	1026.0	898.0	984.7	1002.3	1022.1	1059.9
% of GNP	25.4	24.5	24.0	23.7	23.5	23.3	23.1	23.0	23.8	24.7	23.9	23.1	22.5
Deficit(NIPA)	-224.2	-203.3	-183.1	-171.2	-165.1	-159.0	-156.7	-153.9	-172.9	-199.3	-180.7	-153.8	-137.6
% of GNP	-5.5	-4.9	-4.4	-4.1	-3.9	-3.7	-3.6	-3.4	-4.6	-5.0	-4.3	-3.5	-2.9
% of Net Domestic Savings	-72.7	-61.4	-57.5	-54.6	-52.0	-49.8	-48.6	-47.0	-51.1	-63.1	-56.4	-47.3	-39.8

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns.

TABLE 3

MAY 1986

REAL ESTATE AND FINANCIAL MARKETS

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1984	1985	1986	1987	1988
REAL ESTATE MARKETS													
Total Single-Family Home Sales (single-family resales and completions)	4,542	4,479	4,573	4,665	4,765	4,725	4,664	4,608	3,933	4,255	4,620	4,641	4,500
Percent Change -- Year Ago	18.6	11.3	12.1	6.6	4.9	5.5	2.0	-1.2	4.9	8.2	8.6	0.4	-3.0
Existing Single-Family Sales (1000's)	3,500	3,266	3,412	3,499	3,589	3,551	3,502	3,452	2,868	3,215	3,442	3,479	3,340
Percent Change -- Year Ago	24.4	10.5	12.1	4.1	2.5	8.7	2.6	-1.3	5.7	12.2	7.0	1.1	-4.0
Dollar Volume (billions)	318.9	308.2	358.2	376.8	374.6	389.1	398.8	403.5	247.1	291.4	354.5	394.5	408.7
Existing Home Prices - Median ($1000's)	75.2	78.2	80.0	81.3	79.7	82.1	84.2	85.6	72.4	75.5	79.8	84.0	88.2
Percent Change -- Year Ago	4.5	5.9	6.0	6.1	6.0	5.1	5.2	5.3	3.6	4.3	5.7	5.3	5.0
Monthly Mortgage Payment (P&I, 80%, 30 yr.)	564.5	543.0	506.8	502.3	476.7	479.8	488.3	490.8	665.1	612.9	507.2	483.9	493.1
Percent of Median Family Income	25.6	24.3	22.5	22.2	20.9	20.8	21.0	20.9	32.0	28.4	22.5	20.7	20.3
Housing Starts (1000's)	1,773	1,993	1,951	1,941	1,931	1,928	1,906	1,896	1,763	1,741	1,954	1,902	1,870
Percent Change	5.2	12.4	-2.1	-0.5	-0.5	-0.2	-1.1	-0.5	3.4	-1.2	12.2	-2.6	-1.7
Single-Family Units (1000's)	1,074	1,250	1,197	1,202	1,212	1,211	1,196	1,192	1,100	1,073	1,215	1,198	1,196
Percent Change	2.5	16.4	-4.3	0.4	0.9	-0.1	-1.0	-0.5	3.3	-2.5	13.3	-1.4	-0.1
Multi-Family Units	699	743	754	739	719	717	708	704	663	669	739	704	673
2-4 Family Units (1000's)	80	103	105	103	100	100	99	98	122	93	103	98	94
Percent Change	-9.1	29.6	1.5	-1.9	-2.7	-0.3	-1.2	-0.6	7.0	-23.4	10.4	-3.7	-4.4
5+ Family Units (1000's)	620	640	649	636	619	617	610	606	542	576	636	606	580
Percent Change	15.2	3.2	1.4	-1.9	-2.7	-0.3	-1.2	-0.6	2.8	6.2	10.5	-4.7	-4.4
Mobile Homes Shipped (1000's)	288	271	266	269	272	274	274	275	295	283	269	275	281
New Single-Family Home Sales (1000's)	696	782	792	744	742	698	678	670	639	689	765	683	754
Percent Change -- Year Ago	12.8	17.2	16.5	4.6	6.6	-10.7	-14.4	-9.9	1.7	8.1	11.1	-10.7	10.4
New Home Prices - Median ($1000's)	87.1	87.1	88.9	90.5	91.8	92.8	94.2	95.4	80.0	84.2	89.6	94.7	100.3
Percent Change -- Year Ago	8.5	5.1	5.8	9.3	5.4	6.5	6.0	5.4	6.1	5.3	6.4	5.7	5.9
New Home Prices--Mean ($1000's, Quality Adj.)	106.4	104.5	108.1	109.2	110.2	108.0	111.7	112.8	96.8	104.0	108.0	111.6	116.3
Percent Change -- Year Ago	7.5	3.3	3.8	4.7	3.6	3.3	3.4	3.3	6.6	7.4	3.8	3.3	4.2
NAR Affordability Index	99.3	100.5	108.5	110.3	117.1	117.4	116.3	116.7	89.1	95.5	109.1	117.9	120.6
Mortgage Debt Outstanding ($ billions)	2,386	2,334	2,437	2,514	2,593	2,671	2,748	2,824	1,948	2,202	2,470	2,786	3,093
Housing Inventory (millions)	95.8	96.3	96.8	97.3	97.8	98.3	98.8	99.2	93.4	95.2	97	99	100.9
Rental Vacancy Rate(%)	6.7	6.7	6.8	6.9	6.8	6.7	6.8	6.7	5.8	6.5	6.8	6.7	6.4
Office Vacancy Rate (%)<1>	16.5	16.6	17.0	17.4	17.6	17.9	18.0	17.7	13.9	16.0	17.2	17.8	16.9
Industrial Vacancy Rate (%) <1>	4.9	4.9	4.8	4.6	4.5	4.3	4.3	4.2	4.7	4.7	4.7	4.3	4.0
FINANCIAL MARKETS													
Money Supply (M1)(% change)	11.1	7.9	7.4	6.4	5.8	7.1	5.8	5.5	7.0	9.1	9.1	6.2	4.9
Velocity of M1 (% change)	-6.1	-1.9	-2.7	-0.7	0.0	-0.8	-0.5	0.2	3.7	-3.1	-3.7	-0.5	1.3
Value of the U.S. Dollar (Trade-Weighted)	1.282	1.195	1.130	1.119	1.107	1.096	1.085	1.071	1.383	1.432	1.138	1.077	1.057
Percent Change	-28.1	-24.5	-20.0	-4.0	-4.0	-4.0	-4.0	-5.0	10.4	3.5	-20.6	-5.3	-1.8
Flow of Funds (NIA Basis) (Billions of dollars,saar)													
Sources:(total:gross savings)													
Private Saving	697	718	717	722	735	744	757	772	693	695	723	765	823
Personal Saving	115	124	122	114	110	109	108	108	173	129	118	108	111
Savings Rate	4.0	4.3	4.2	3.9	3.7	3.6	3.5	3.5	6.5	4.6	4.0	3.5	3.5
Gross Business Savings	582	594	594	608	625	635	650	665	521	566	605	657	712
Federal Deficit	-224	-203	-183	-171	-165	-159	-157	-154	-173	-199	-181	-154	-138
State & Local	59	64	60	58	59	60	59	58	64	59	60	59	63
Net Foreign Investment	-153	-130	-131	-127	-123	-116	-119	-120	-91	-115	-128	-118	-107
Uses (total:gross investment)	681	708	718	732	748	763	777	794	674	669	727	786	852
Nonresidential Investment	487	469	479	484	492	497	500	505	430	472	481	503	523
Structures	169	167	167	167	169	171	172	174	149	166	167	173	180
Equipment	318	303	312	316	323	327	328	331	282	306	313	330	343
Residential Investment	176	180	185	186	186	186	186	185	168	171	184	185	184
Inventory Investment ($ billions)	-6	26	18	19	20	23	28	33	63	6	21	31	41
Selected Interest Rates (%)													
Mortgage Rates													
30-year Fixed Rate Mortgage	11.3	10.4	9.5	9.3	9.0	8.8	8.7	8.6	13.8	12.2	9.6	8.7	8.4
Real Mortgage Rate	8.0	7.9	6.9	6.7	6.8	5.9	5.6	5.5	9.7	8.9	6.8	5.9	5.1
1-year ARM (without buydown)	9.5	9.2	8.0	7.9	7.7	7.6	7.4	7.4	12.6	10.1	8.2	7.5	7.6
Real Mortgage Rate	6.2	6.7	5.4	5.3	5.5	4.7	4.3	4.3	8.5	6.8	5.4	4.7	4.3
Corporate AAA Bond Rate	10.6	9.6	8.5	8.4	8.1	7.9	7.6	7.5	12.7	11.4	8.7	7.6	7.3
Government Bond Rate	10.2	8.9	7.3	7.2	7.0	6.8	6.7	6.7	12.5	11.0	7.6	6.7	6.6
Real Government Bond Rate	6.9	6.4	4.7	4.6	4.8	3.9	3.6	3.6	8.4	7.7	4.8	3.9	3.3
Federal Funds Rate	8.1	7.8	7.0	6.6	6.3	6.0	5.8	5.6	10.2	8.1	6.9	5.7	5.8
3-month T-Bill Rate	7.2	7.0	5.9	5.5	5.3	5.2	5.1	5.1	9.5	7.5	5.9	5.1	5.4
Real 3-month T-Bill Rate	3.9	4.5	3.3	2.9	3.1	2.3	2.0	2.0	5.4	4.2	3.1	2.3	2.1
1 Year T-Bill Rate	7.9	7.5	6.3	6.2	6.0	5.9	5.7	5.7	10.9	8.4	6.5	5.7	5.9
Real 1-Year T-Bill Rate	4.6	5.0	3.7	3.6	3.8	3.0	2.6	2.6	5.2	4.0	3.7	3.0	2.6
Prime Rate	9.5	9.4	8.8	8.5	8.3	8.0	7.7	7.4	12.0	9.9	8.8	7.5	7.2
Discount Rate	7.5	7.4	6.7	6.4	6.2	5.8	5.7	5.6	8.8	7.7	6.7	5.7	5.7

<1> Historical Data courtesy of Coldwell Banker.
<2> FHA Secondary Mortgage Market rate.

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns.

Special Supplement:

Where Has the Deficit Gone?

For the past several years federal budget projections have been cause for despair. Federal deficits of $200 billion or more for ". . . as far as the eye can see" were the conventional wisdom. In fact, just last August the Congressional Budget Office (CBO) released its updated baseline which projected a deficit of nearly $300 billion by 1990[1/]. This gloomy forecast no doubt contributed to the sense of urgency which lead to the passage of the Balanced Budget and Emergency Deficit Control Act of 1985 or Gramm-Rudman-Hollings (GRH) which requires Congress and the President to adopt budgets with declining deficits and a balanced budget by 1991.

Since then there has been a fundamental change in CBO's deficit projection. In their February "Economic and Budget Outlook, 1987-1991," CBO projects that with no changes in current policies and economic growth of between 3 and 3-1/2 percent per year, the federal deficit will shrink from its current level of $208 billion to $104 billion by 1991. In terms of its burden on the economy the deficit would fall from its current 5 percent of GNP to 1.7 percent in 1991. As shown in Table 4, 60 percent of the downward revision of the deficit projection comes from lower defense outlays, 25 percent comes from lower net interest outlays due to the lower deficit and to lower interest rates, and 22 percent comes from reduced outlays for nondefense discretionary programs. Other assorted policy and economic changes combine to increase the deficit slightly.

Understandably, such a dramatic change in the deficit projections have caused considerable debate, not only over whether or not they are realistic from a purely economic viewpoint but also over the political implications. Some interested parties have argued that the deficit outlook has indeed improved this much, that in fact the CBO baseline is pessimistic given recent favorable economic developments, so that drastic spending cuts and possible tax increases are not required to achieve the GRH deficit target of $144 billion for FY 1987. In contrast, others argue that the CBO baseline is unrealistically optimistic and that Congress and the Administration will have to make some hard decisions regarding spending cuts and possible tax increases to meet the deficit target required by law.

The following is a brief discussion of some of the key issues underlying the debate over the CBO baseline:

1) Economic Assumptions

Deficit projections are extremely sensitive to the overall growth rate of the

---

[1/] CBO's baseline projection of future federal deficits assumes that no changes are made in current federal spending and taxation policies. The February 1986 baseline accounts for the March 1 GRH sequestration of $11.7 billion but assumes no further GRH spending reductions nor does it include all of the deficit reduction impacts of the Consolidated Budget Reconciliation Act of 1986. Regarding the economy, the baseline combines an economic forecast for 1986 and 1987 with assumptions about the state of the economy for 1988 through 1991 based on average historical experience. The baseline is not intended as a forecast of the deficit, particularly for the out-years, but rather a benchmark against which policy changes can be evaluated.

Table 4

Changes in CBO Baseline Deficit
Projections Since August 1985
(By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	1991
August 1985 Baseline	212	229	243	264	285	NA
Major Changes:						
Lower Defense Outlays	-9	-26	-48	-71	-96	NA
Lower Net Interest Costs	a/	-7	-16	-31	-51	NA
Lower Nondefense Discretionary Program Outlays	-10	-19	-20	-21	-22	NA
Other Changes	15	5	6	3	4	NA
Total Changes	-4	-48	-78	-120	-165	NA
February 1986 Baseline	208	181	165	144	120	104

a/Less than $500 million.

NA - Not Available

Source: Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1987-1991", February 1986, page xxi.

economy that is assumed. Faster economic growth tends to reduce the deficit by resulting in larger federal revenues and lower federal outlays for income-support programs such as unemployment compensation and food stamps. In its February publication CBO presented three deficit projections based on three different economic scenarios; high economic growth, baseline economic growth (CBO's estimate of the most likely course for the economy), and low economic growth which assumes a recession in 1987 and 1988. Table 5 presents the assumed growth rates and resulting deficits for each of these scenarios. As can be seen, under the low-growth alternative, by FY 1988 the deficit is $100 billion greater than under the baseline.

Table 5

Alternative Economic and Deficit Projections

	1986	1987	1988	1989	1990	1991
Real GNP[a/]						
High Growth	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low-Growth	3.0	-0.7	-0.8	5.4	3.4	3.2
Deficit (-) or Surplus						
High Growth	-202	-154	-111	-61	-1	70
Baseline	-208	-181	-165	-144	-120	-104
Low-Growth	-210	-224	-282	-271	-238	-237

a/By calendar year; year-over-year changes.

b/By fiscal year, in billions of dollars.

Source: Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1987-1991", February 1986, page xxiii.

Now it is true that since CBO produced the February baseline there have been some very favorable economic developments. Oil prices and the value of the dollar have fallen dramatically. Due to lowered inflation expectations interest rates have fallen and are now below levels assumed in the CBO baseline. However, despite these favorable developments economic growth remains sluggish. Many private forecasters now predict considerably slower growth of the economy than was assumed in the baseline; in the 2 to 3 percent range for the 1986 to 1988 period and 3 percent as the long-term trend growth rate for the 1989 to 1991 period. Thus, while it is by no means a view held by all private economists, many would argue that CBO is overly optimistic in its baseline economic growth projections.

2) Defense Spending

As shown in Table 4, deficit projections are also extremely sensitive to what is assumed regarding growth of defense spending. The August 1985 CBO baseline assumed that defense spending would increase at 5-1/2 percent per year in real or inflation adjusted terms, consistent with the fiscal 1985 budget resolution. In contrast, the February 1986 CBO baseline assumes no real growth of defense spending, meaning that defense spending will increase only at the rate of inflation. This change reduces defense spending by $250 billion over the 1986 to 1991 period and further reduces federal outlays since with a lower deficit there is a slower accumulation of federal debt and so reduced net interest outlays. While zero real growth of defense spending is consistent with the baseline concept since this is roughly what was approved for the fiscal 1986 budget, it seems unlikely to occur given the strong preference for increased defense spending within the Reagan Administration and among a not-insignificant number of members of Congress.

Table 6 presents the NAR baseline which is based on our forecast for the growth of real GNP, inflation, and interest rates. Two scenarios are presented for the NAR baseline, zero real growth of defense spending and three percent real growth of defense spending. Under the three percent real growth of defense spending scenario the overall growth rate of the economy is somewhat faster which in effect pays for some of the increased defense spending through higher tax revenues.

Note that even with no real growth of defense, the decline in the deficit is about 30 billion less per year. With three percent real growth of defense the deficit would be $40 to $50 billion higher per year. Thus, the amount of deficit reduction required to meet the FY 1987 GRH target of $144 billion is at least $30 billion more than is currently being assumed by Congress. Recent reports that Congress is finding that GRH deficit reduction is not the "bitter pill" once thought is due to the fact that much of the illness has been assumed not to exist.

Table 6

CBO Baseline Deficit Versus NAR
Baseline Deficit with Alternative Real
Growth Rates for Defense Spending

	1986	1987	1988	1989	1990	1991
Gramm-Rudman-Hollings Targets	171	144	108	72	36	0
CBO Baseline	208	181	165	144	120	104
NAR Baseline Real Growth of Defense:						
0%	205	211	191	171	156	133
3%	205	220	205	184	169	150

Source: NATIONAL ASSOCIATION OF REALTORS®

REALTOR®